AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

FASB FLASH REPORT

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FASB Offers a Practical Expedient on the Issuances of Equity-Classified Awards for Private Companies

Summary: The FASB issued ASU 2021-07[1] ("Update") to address the concerns from stakeholders about the cost and complexity of determining the fair value of equity-classified share-based awards for private companies. It specifically permits private companies to use 409A valuations prepared under US Treasury regulations to estimate the fair value of certain awards under ASC 718. The Update is available **here** and is effective for private companies in fiscal years starting after December 15, 2021. Early adoption is permitted.

1 [Compensation—Stock Compensation (Topic 718), Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards, a consensus of the Private Company Council

BACKGROUND

Under existing guidance in ASC 718, a company that issues an equity-classified share-based award typically utilizes an option pricing model to determine the award's fair value. The option pricing model requires several inputs, including the fair value of the underlying equity share. The Private Company Council received feedback from stakeholders that determining the fair value of the underlying equity share for these awards can be challenging and costly for private companies whose shares do not trade on active markets or have observable prices.

MAIN PROVISIONS

Under the Update, a private company is allowed to use a reasonable valuation method to measure the fair value of the underlying equity share of a share-based award that is classified within equity. That is, companies are not permitted to use this practical expedient for liability-classified awards.

The following are characteristics of a reasonable application of a reasonable valuation method, consistent with a 409A valuation performed for tax purposes:

- The reasonableness of the valuation should be assessed on the measurement date.
- All information that is material to the company should be assessed as part of the valuation.
- Other elements that should be considered in a reasonable valuation include:
  - The value of the company's tangible and intangible assets
  - The company's present value of expected future cash flows
  - Market value of stock or equity issued by competitors or other companies engaged in substantially similar business activities
  - The company's recent sales or transfers of stock or equity interests with third parties
  - Other relevant considerations such as control premiums or discounts for a lack of marketability of the shares, or potential other uses for the valuation
  - The company's prior use of a valuation method and whether it was consistently applied.

If a private company is assessing whether a previously calculated fair value for an underlying share is reasonable to use for a new equity-classified award, the following should also be considered in the valuation:

- Any information that is available after the date of the original calculation that may materially affect the valuation should be evaluated and the original calculation adjusted if applicable.
- The original calculation must have been performed twelve months or less from the issuance date of the new equity-classified award.

Although a reasonable valuation method is not required to be conducted by a third party, many companies obtain external valuations to satisfy US Treasury Regulations. The FASB intends for those valuations to also satisfy the requirements of this new practical expedient in ASC 718.

EFFECTIVE DATES AND TRANSITION:

The Update is effective on a prospective basis for qualifying awards issued or modified in fiscal years starting after December 15, 2021 and interim periods starting after December 15, 2022. Early adoption, including adoption in an interim period, is allowed for financial statements that have not been issued or made available for issuance as of October 25, 2021.

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